



## U.S. SENATE REPUBLICAN POLICY COMMITTEE

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# Taxing Success: President Obama's Tax Increases on Small Businesses are Bad for Job Creation

### *Executive Summary*

- President Obama's budget taxes too much by targeting small businesses that are responsible for a significant share of job creation.
- The Administration's stated goal is job creation yet they have proposed policies that increase taxes and decrease profits on those engines of job creation.
- Those tax increases are:
  - Raising the top two tax brackets from 33 percent and 35 percent, to a nominal rate of 36 and 39.6 percent, respectively;
  - Bringing back the "hidden tax increases" of PEP (the Personal Exemption Phaseout) and Pease (the limitation on itemized deductions); these limitations actually raise the effective marginal rates to 40 and 41 percent; and
  - Limiting the amount that certain small-business owners and others can take in itemized deductions to just 28 percent even though they pay tax at rates much higher rates.
- Although the Obama Administration has played down the impact of these tax increases by focusing on the percentage of taxpayers with small business income, small businesses targeted by these tax increases create a large number of small business jobs.
- Two-thirds of jobs at small businesses in 2006 were at businesses where the Obama tax hikes are targeted (businesses with between 20 and 499 employees).
- Research has shown that raising taxes on businesses depresses investment and that lowering taxes on businesses increases employment and raises wages.
- Delaying the tax increases two years does not make them hurt less—small business owners plan well in advance of tomorrow and they don't want to hire someone today if they know they will be forced to lay them off tomorrow.

## **Introduction**

President Obama has proposed a budget outline that he calls “A New Era of Responsibility.” Part of the new era of responsibility is that many of the president’s new proposed programs are paid for by raising taxes on those who have achieved economic success—including the small businesses that have proved to be the engines of growth in the American economy. While the Administration has often promised to “save or create” millions of new jobs, the tax policies in the budget target the very same small businesses that have created 60-80 percent of the net new jobs over the last decade.<sup>1</sup>

## **What is a small business?**

The Small Business Administration (SBA), the agency of the United States government responsible for overseeing the government’s small business contracting and lending programs, defines a small business either by the size of average annual receipts (generally for service and retail firms), by an asset test (generally for banks), or by the number of employees at a firm (generally for manufacturing firms).<sup>2</sup> For purposes of this paper, 500 employees will be considered the maximum size of a small business.

## **How do small businesses pay taxes?**

Small businesses, like large businesses, can choose to pay their taxes either at the corporate level, where they would face the United States’ high 35 percent corporate tax rate, or at the individual level. Firm owners who choose to pay taxes at the individual level avoid the double taxation of income (once at the corporate level, again at the individual level) by paying taxes on the revenue from their businesses on their individual tax returns. These firms are known alternately as flow-through or pass-through businesses and include businesses organized as subchapter S corporations, sole proprietorships, LLCs, and partnerships. Of the 32 million businesses in the United States, 93.8 percent choose one of these corporate forms, and these businesses account for 35 percent of all business receipts.<sup>3-4-5</sup>

## **How does the Obama budget raise taxes on small businesses?**

For small businesses that choose to pay taxes at the individual level, the proposed Obama budget raises taxes on them in three different ways:

- By raising the top two tax brackets from 33 percent and 35 percent, to statutory marginal rates of 36 and 39.6 percent, respectively;

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<sup>1</sup> According to the SBA Office of Advocacy: <http://web.sba.gov/faqs/faqIndexAll.cfm?areaid=24>

<sup>2</sup> Table of Small Business Size Standards Matched to North American Industry Classification System Codes, SBA [http://www.sba.gov/idc/groups/public/documents/sba\\_homepage/serv\\_sstd\\_tablepdf.pdf](http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf). These size standards vary by industry, but the revenue ceiling goes from \$750,000 in revenue to \$35,500,000; the employment ceiling goes from 500 employees to 1,500.

<sup>3</sup> Internal Revenue Service, Statistics of Income, Table 2 – Number of Businesses, Business Receipts, Net Income and Deficit, by Form of Business and Industry, Tax Year 2003

<sup>4</sup> See IRS publication: Kelly Lettrell, Patrice Treubert, and Michael Parisi, *Integrated Business Data*, 2003.

<sup>5</sup> *Tax Reform: Selected Federal Tax Issues Relating to Small Businesses and Choice of Entity*, testimony prepared by the staff of the Joint Committee on Taxation, June 5, 2008; <http://www.house.gov/jct/x-48-08.pdf>

- By bringing back the “hidden tax increases” of PEP (the Personal Exemption Phaseout) and Pease (the limitation on itemized deductions); these limitations actually raise the effective marginal rates to 40 and 41 percent, respectively;<sup>6</sup> and
- By limiting the amount that small-business owners, and everyone else, can take in itemized deductions if they make more than \$200,000 if single, or \$250,000 if married, to just 28 percent, even though they pay tax at the 39.6 or 36 percent rates.

President Obama’s tax hikes would mean a 20 percent increase in tax rates for successful flow-through small businesses. The Tax Foundation has estimated that roughly 50 percent of the approximately \$70 billion in annual revenue raised from rolling back the top two rates to where they were in 2000 can be attributed directly to flow-through income.<sup>7</sup>

While the higher marginal rates and the PEP and Pease provisions are phased-out features of current law that are set to return in 2010, the 28 percent deduction limitation is a new proposal introduced by the Administration. This proposal would take away some of the tax incentives in current law for activities that are perceived to be socially beneficial, such as charitable giving. Currently, if a small business gives \$100 to charity, the small business owner in the top bracket would normally be able to reduce income tax liability by \$39.60 (\$100 multiplied by their tax rate of 39.6 percent, the level envisioned by the Obama budget), effectively lowering the cost to the taxpayer of their charitable donation and providing an incentive for charitable giving. The Administration’s budget has essentially proposed that a small business owner making the same donation would only be able to reduce tax liability by \$28 (\$100 multiplied by the 28 percent rate), lessening the tax incentive for charitable giving.

Administration officials have argued this is fair because under President Reagan, people could only deduct their charitable donations at a 28 percent rate, which was at the time the top tax rate. Under the principle that taxpayers should be able to take deductions at their highest rate, this proposal unfairly denies a common benefit enjoyed by all taxpayers who itemize deductions when paying their taxes. This was the justification given by Congress and the Joint Committee on Taxation when PEP and Pease were originally repealed.<sup>8</sup>

### **How will the tax hikes affect small business employment?**

Unfortunately, because the IRS does not collect data on the number of employees at flow-through businesses who pay taxes in the top two brackets, we have to rely on survey and other data to get an idea of how these tax hikes will affect small businesses. A 2007 poll done by the Gallup organization for the National Federation of Independent Business (NFIB) separated small business owners by employee size and expected income.<sup>9</sup> The results are reproduced below:

<sup>6</sup> A paper by Robert Carroll of the Tax Foundation explains how PEP and Pease raise marginal tax rates above the statutory rate: <http://www.taxfoundation.org/news/printer/23724.html>; a 2001 Senate Finance Republican analysis of the PEP and Pease provisions found that these provisions raise the effective marginal rates to 40 and 41 percent.

<sup>7</sup> Robert Carroll, *The Effect of the Presidential Candidates’ Tax Plans on Flow-Through Businesses*, Tax Foundation: <http://www.taxfoundation.org/publications/show/23824.html>

<sup>8</sup> Conference Report, the Economic Growth and tax Relief Reconciliation Act of 2001, [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107\\_cong\\_reports&docid=f:hr084.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_reports&docid=f:hr084.pdf)

<sup>9</sup> National Small Business Poll: *Finance Questions*, Volume 7, Issue 7, 2007.

Is your total household income from all sources for the year, including income from other adult members of the household, likely to be:	Employee Size of Firm			
	1-9	10-19	20-249	All Firms
< \$12,500	0.8	—	—	0.6
\$12,500 - \$24,999	2.8	—	—	2.3
\$25,000 - \$37,499	1.6	2.9	—	1.7
\$37,500 - \$49,999	4.0	2.9	—	3.6
\$50,000 - \$62,499	6.8	2.9	5.0	6.3
\$62,500 - \$74,999	12.5	8.8	5.0	11.6
\$75,000 - \$99,999	12.1	11.8	5.0	11.6
\$100,000 - \$124,999	12.1	11.8	10.0	11.9
\$125,000 - \$149,999	11.6	14.7	5.0	11.6
\$150,000 - \$199,999	11.6	14.7	15.0	12.2
<b>\$200,000 - \$249,999</b>	<b>5.6</b>	<b>5.9</b>	<b>10.0</b>	<b>5.9</b>
<b>\$250,000 or more</b>	<b>6.4</b>	<b>20.6</b>	<b>40.0</b>	<b>10.2</b>
Don't know or refused	12.0	2.9	5.0	10.6

Source: NFIB

NFIB found that 50 percent of businesses in their survey that had between 20 and 249 employees had income of \$200,000 or more—the exact group of business owners the Obama Administration has proposed raising taxes on. Only 6.3 percent of businesses filed as C corporations in 2005—the rest were pass-throughs who paid taxes at the individual level.<sup>10</sup> Therefore a large number of these firms that employ 20-249 workers are going to be firms that pay taxes at the individual level.

This group is only a subsection of the small businesses that employ 500 or fewer workers as defined by the SBA. While this Gallup survey does not contain data for the small businesses with 250 to 499 employees, the trend in the survey is for larger employers to have more household income, and recent work by the Senate Finance Committee minority staff argues that it is a fair assumption that at least 50 percent of businesses that employ between 250-499 employees would also make over \$200,000.<sup>11</sup>

SBA data shows how important these small businesses with 20 to 499 employees are. In 2006, 64 percent, or nearly two-thirds, of employment in small businesses came from small businesses with 20 to 499 employees.

	Total businesses	20-499	Employment Size of Firm	
			Total Small Businesses (under 500 employees)	Small businesses with 20-499 employees as a percent of total small businesses
Firms	6,022,127	626,425	6,004,056	10%
Establishments	7,601,160	1,043,474	6,472,647	16%
Employment	119,917,165	38,614,220	60,223,740	64%
Annual payroll	\$4,792,429,911	\$1,402,732,868	\$2,128,793,097	66%

Source: SBA

<sup>10</sup> JCT testimony on small businesses and choice of entity: <http://www.house.gov/jct/x-48-08.pdf>

<sup>11</sup> <http://finance.senate.gov/press/Gpress/2008/prg091108.pdf> and Senator Chuck Grassley's Weekly Republican Address, March 14, 2009

In other words, the 10 percent of small businesses that employ the most people are the ones targeted by the tax increases in the Administration's budget. The Administration should not be targeting these small businesses that account for nearly two-thirds of all small business employment with job-killing tax hikes.

**Since the percentage of all small businesses affected by the tax increases is relatively low, why will the impact on jobs be high?**

In testimony before Congress, representatives of the Obama Administration have tried to focus the small business debate on the percentage of small businesses affected by their tax hikes. Since this number is relatively small, it serves to distract from the more important number, which is the percentage of small business jobs that are affected.<sup>12</sup>

Secretary Geithner has testified before the Ways and Means Committee and Senate Finance Committee that only three percent of small business owners will get hit with the Administration's tax rate increases. This is because many taxpayers with "small business income" are reporting incidental income that doesn't create jobs, such as rental income or residuals from giving a speech. Although Secretary Geithner has not revealed the source of these estimates, press reports suggest that Secretary Geithner's statements appear to be based on results from the liberal Tax Policy Center's "Microsimulation Model."<sup>13</sup>

In contrast to the projections of the liberal Tax Policy Center, the Treasury Department, which Secretary Geithner now heads, is a government agency that used actual IRS data to come up with its numbers. In the background paper for the 2007 Conference on Business Taxation and Global Competitiveness, the Treasury Department's Office of Tax Analysis found that in the 2006 tax year, summarized below, for small business owners whose flow-through income was greater than 50 percent of their wages, nine percent of these small-business owners were in the top two tax brackets. These are the brackets that the Administration's budget hits with tax hikes.

Flow-through income greater than 50 percent of income	Taxpayers with flow-through income/loss (millions of taxpayers)	Flow-through income/loss (billions)	Tax on flow-through income/loss (billions)
All taxpayers	11.9	\$880	\$156
Taxpayers in top two tax brackets	1.1	\$608	\$127
Percent for taxpayers in top two tax brackets	9%	69%	81%

It is important to only look at the subset of taxpayers who take more than 50 percent of their personal income as business income because this group is more representative of taxpayers who have actual businesses and are not collecting income from an incidental activity such as speech giving or rental income that does not create jobs. One limitation of both the Treasury data and the Tax Policy Center data is that it includes "any tax unit that receives any income (or loss)

<sup>12</sup> This mistake is commonly made in the media, see for example:

[http://news.yahoo.com/s/ap/20090226/ap\\_on\\_go\\_co/fact\\_check\\_budget](http://news.yahoo.com/s/ap/20090226/ap_on_go_co/fact_check_budget)

<sup>13</sup> "Centrists Worry About Budget's Impact on Small Business," *CongressDaily AM*, Friday, March 6, 2009

from a sole proprietorship, farm proprietorship, partnership, S corporation, or rental income.” This is generally agreed to be an overbroad definition of small business.

Treasury finds that in this category those small business owners in the top two brackets earned 69 percent of all small business flow-through income and paid an astounding 81 percent of the tax paid by all flow-through small business owners. In addition to the jobs that are affected by the Administration’s tax hikes, the vast majority of small business income is concentrated among those small business owners that pay tax in the top two income tax brackets. This income is funneled back into the local communities where these small businesses are based through charitable donations, normal everyday purchases, and investments in the local economy.

### **How will tax hikes in the future affect business activity now?**

By signaling willingness to delay these tax hikes, administration officials have acknowledged that raising taxes would be destructive to economic activity, job creation, and growth.<sup>14</sup> This is always true, but it is especially true during an economic slowdown. To avoid raising taxes in a downturn, the tax hikes in the proposed Obama budget do not take effect until the end of 2010, when it is not at all clear that the economy will have markedly improved. However, delaying these tax increases will not eliminate their negative impact, because small business owners plan well in advance of tomorrow. Businesses operating on tight margins will not want to hire someone today if they know they will be forced to lay them off in less than two years.

Research by the Tax Foundation shows that higher income taxes reduce the likelihood and the amount of investment spending by entrepreneurs, and that lowering tax rates increases the likelihood of hiring and increased median wages for hired workers. Raising the marginal tax rate five percentage points reduces the percentage of entrepreneurs who invest by 10.4 percent and lowers their average investment by 9.9 percent. Reducing the tax rate from 39.6 to 33.2 percent increases the likelihood of hiring by 12 percent and raises the median wage for those hired employees by 3.2 percent.<sup>15</sup> Research also shows that anticipated tax increases have a direct effect on activity today, as business owners are rational and forward looking and so respond to anticipated higher taxes by scaling back investment and hiring.<sup>16</sup>

### **Conclusion**

The president’s proposed budget raises taxes on small businesses at a dangerous time. Raising taxes on small businesses that are responsible for a significant portion of job creation is never a good idea, but it is an especially bad idea when the economy is weak and business owners need to have the most possible confidence that investments they make today will not be taken away by the government tomorrow. By proposing a budget that taxes all Americans too much, the Administration is injecting uncertainty at a time they should be providing confidence.

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<sup>14</sup> “Obama might not raise taxes on rich due to weak economy,” *Chicago Sun Times*, September 7, 2008.

<sup>15</sup> Robert Carroll, *The Effect of the Presidential Candidates’ Tax Plans on Flow-Through Businesses*, Tax Foundation: <http://www.taxfoundation.org/publications/show/23824.html>

<sup>16</sup> For a review of the theory behind this, please see the Royal Swedish Academy of Sciences paper on the work of Ed Prescott, available at: [http://nobelprize.org/nobel\\_prizes/economics/laureates/2004/ecoadv.pdf](http://nobelprize.org/nobel_prizes/economics/laureates/2004/ecoadv.pdf)